



HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref.: B1/15C
B9/75C
S4/2C
S4/3C

19 January 2016

The Chief Executive
All Locally Incorporated Authorized Institutions

Dear Sir/Madam,

Revised Framework for Market Risk Capital Requirements

As you may be aware, the Basel Committee on Banking Supervision (BCBS) issued on 14 January 2016 its final standards on *Minimum Capital Requirements for Market Risk*¹.

The revised market risk capital framework is a key component of the BCBS's reform of global regulatory standards in response to the global financial crisis, which exposed material weaknesses in the capital framework for market risk. The "Basel 2.5" market risk reforms issued by the BCBS in 2009 addressed the most pressing deficiencies while the new set of standards addresses outstanding structural shortcomings in the market risk capital framework. The new market risk standards are scheduled to be implemented by national supervisors by 1 January 2019; and banks are required to start regulatory reporting based on the revised standardised approach (SA) or internal models approach (IMA) (with use of the latter being subject to supervisory approval) from 31 December 2019.

The key features of the revised market risk capital framework include:-

¹ See <https://www.bis.org/bcbs/publ/d352.pdf>.

- (a) Revised boundary: The boundary between the regulatory trading book and banking book has been revised to reduce incentives for arbitrage of regulatory capital requirements between the two books, while continuing to respect banks' risk management practices. Notably, stricter limits and capital disincentives are applied to the transfer of risk positions between the banking book and trading book;
- (b) Revised internal models approach: The revised IMA replaces the value-at-risk-based IMA in the current framework with one that is based on expected shortfall designed to better capture "tail risks" and market illiquidity risks. This is accompanied by a more rigorous and granular model approval process down to the level of the regulatory trading desk; and
- (c) Revised standardised approach: The SA has been revised to make it sufficiently risk-sensitive to serve as a credible fallback as well as a floor to the IMA, while still providing an appropriate standard for banks that do not require a sophisticated treatment for market risk. The revised SA involves a more extensive use of risk sensitivities as inputs to market risk calculations and has three main components, i.e. a *sensitivities-based method* for capturing risk sensitivities, a standardised *default risk charge* and a *residual risk add-on*.

The HKMA's current intention would be to implement the revised market risk capital framework in accordance with the BCBS timetable and so the HKMA will consult the industry on its implementation proposals for Hong Kong in due course, taking account of the progress of the BCBS in finalising related standards that may have an impact on the framework². As the revised market risk capital framework in effect represents a significant overhaul of the current market risk capital framework, it is likely to have impacts on, among other things, the capital requirements, systems, data and resources of locally incorporated authorized institutions (AIs), particularly

² The BCBS highlights that a number of aspects of its ongoing work may have an impact on the revised market risk capital framework, including the proposal for incorporating criteria for simple, transparent and comparable securitisations into the Basel capital framework, the application of the market risk capital framework to credit valuation adjustments, as well as the ongoing review of capital treatment for credit risk and the treatment of interest rate risk in the banking book.

for those with material market risk exposures. All relevant AIs are therefore strongly recommended to familiarise themselves with the new market risk capital standards in advance of any HKMA consultations, consider the implications of implementation for their institutions, and start preparing, to the extent practicable, for the local implementation of the revised framework.

Should you have any questions relating to this letter, please feel free to contact Miss Echo Chan at 2878 1558 or Mr Argus Leung at 2878 1626.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

cc: The Chairman, The Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn: Mr Jackie Liu)